Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N--2879-00
MDFriedman

date:

to: Quality Assurance Branch
Laguna Niguel PSP:OE 30/90
Attn: Wally Muncie

from: Miles D. Friedman, Attorney
Sherri S. Wilder, Assistant District Counsel
Southern California District Counsel, Laguna Niguel

subject: **Review of Proposed Notice of Final Partnership Administrative Adjustment**
Taxpayer: [redacted]
EIN: [redacted]
Years: [redacted]
S/L: [redacted]

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You asked us to review the proposed notice of Final Partnership Administrative Adjustment ("FPAA") in this matter. This case is related to four other cases, which we recently reviewed, and all of which involve [redacted] and concern either his individual tax return or [redacted] trusts. One of the trusts, the [redacted], is the claimed tax matters

partner of this partnership.

Important matter relating to last known address

Initially, we understand that [redacted] currently is incarcerated . Wally Muncie has informed us that Betty Lew has already obtained the prison address for [redacted]. Both a generic FPAA (c/o [redacted]) and an FPAA addressed to [redacted], trustee of the [redacted], TMP of [redacted], should be sent to the prison address. Also, please send a generic FPAA to every other address you know of. This includes any address(es) that you have for the second partner, [redacted].

General Discussion and Recommendations

a. Existence of Partnership

The partnership, [redacted], is, from the face of the Form 1065, U.S. Partnership Return of Income, a TEFRA partnership because a trust, the [redacted] ("Trust"), is one of its two partners. It is not a small partnership exempt from TEFRA. I.R.C. § 6231(a)(1)(B). See, Primco v. Commissioner, T.C. Memo. 1997-332, in which the Tax Court held that grantor trust is a shareholder for the former TEFSA purposes in determining whether the former small S corporation provisions applied to grantor trusts.

[redacted] is also not a small partnership because the "same share" rule has not been met. Harrell v. Commissioner, 91 T.C. 242, 244-249 (1998).[1] As it applies to this case, since one partner, the [redacted], got 100% of the losses, while the two partners each shared 50% of all profits, the "same share" rule has not been met.

This does not mean that because an FPAA must be issued, the Service concedes the existence of [redacted] as an actual partnership. I.R.C. § 6233 specifically permits the Service to issue an FPAA because the entity filed a return as a partnership, even if a court holds the entity was not a partnership for tax purposes. "Congress mandated that the information on the tax return would be determinative of the procedures to be followed,

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[1] As it existed for partnership tax years that began before August 5, 1997, the same share rule required that each partner's share of a partnership item be the same as his share of every other partnership item. I.R.C. § 6231(a)(1)(B)(II) before being amended by P.L. 105-34, § 1234(a). The Harrell case reviews in detail this rule.

even if the underlying facts later prove the return to be incorrect." Harrell v. Commissioner, supra, 91 T.C. at 248.

We do not believe [redacted] is a partnership. In our opinion, the [redacted] is an abusive trust. This opinion was stated in our memorandum, dated May 5, 2000, and was based on the facts as presented in the administrative file for that case. Also, in this case, the Form 1065 Schedule K-1 for the other partner of [redacted], [redacted], reveals that [redacted] made no capital contributions to and received no distributions from [redacted] in [redacted]. ([redacted] was when the partnership started.) Furthermore, the Form 4318 in the administrative file states that no partnership agreement was ever entered into. Based on the lack of federal income tax reality of the three trusts [redacted] has formed, and the lack of any information demonstrating [redacted] is a partnership, in our opinion, [redacted] should be required in court to prove it is a partnership.

Therefore, we believe the Service should determine [redacted] is not a partnership for federal income tax purposes. The explanation of adjustments language should read as follows:

> We have determined that [redacted] is not a partnership for federal income tax purposes. Therefore, the entire amount of the loss ($[redacted]) that was reported on the filed Form 1065, U.S. Partnership Return of Income for [redacted] is disallowed.

b. Gross Income Theory

There are two theoretical approaches that may be taken in abusive trust cases, the "net income" approach and the "gross receipts" approach. Under the "net income" approach, all expenses substantiated are essentially allowed and the resulting net income is transferred to the real party in interest, the individual who set up the trust to avoid income. In general, the theory behind this approach is that the real taxpayer will ultimately be permitted to claim the substantiated amounts in his Schedule C, E, or F businesses, so the Service should eliminate the issue in the first place. We have coordinated with Richard Kennedy, the National Abusive Trust Coordinator in the Office of Chief Counsel. He has informed us that the "net income" approach should be taken only when a taxpayer is cooperative, has good books and records, and just wants to litigate the trust classification issue.

Under the "gross receipts" approach, all of the gross income is considered an admission and no expenses are allowed. Richard Kennedy has stated to us the correct methodology to follow:

For the business trust: (a) disallow the cost of goods sold and the business expenses claimed for lack of substantiation and because they are taken on the wrong taxpayer's return (i.e., we should tax the business trust with the gross receipts of the business); and (b) disallow the income distribution deduction claimed for passing the net income onto the family trust.

As you know, our view is that each of the various [redacted]-related trust entities does not have any basis in reality. Our memoranda to you, dated May 5, 2000, explain the basis of our opinion that the trusts are abusive trusts for federal income tax purposes. Similarly, for the reasons discussed above in part a. of this memorandum, we have taken the view the partnership does not exist. Therefore, for purposes of the FPAA, we should view the partnership as a non-entity and apply the same reasoning as that applied in a Form 1041 "business trust." This means the gross income will be conceded as an admission, while all expenses will be disallowed to this taxpayer. We commend the revenue agent for a thorough review of expenses. If and when this case is reviewed by an appeals officer and the tax matters partner desires to fully cooperate with the Service, then, administratively, the Service can allow the expenses substantiated to date (and more, if more records are forthcoming) to the real party in interest. That real party appears to be [redacted].[2]

As applied to this case, this means we should:

a. Allow as an admission the $[redacted] of gross receipts or sales reported on line 1a of page one of the Form 1065. No language in the FPAA is required here.

b. Disallow all of the returns and allowances of $[redacted], reported on line 1b of page one of the Form 1065.

c. Disallow the entire amount of $[redacted] of cost of goods sold reported on line 2 of page one of the Form 1065.

d. Disallow the entire amount of $[redacted] of salaries and wages reported on line 9 of page one of the Form 1065.

e. Disallow the entire amount of $[redacted] of repairs and maintenance reported on line 11 of page one of the Form 1065.

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[2] The revenue agent has allowed all but $[redacted] of expenses. The loss claimed on the Form 1065 was ($[redacted]). The difference between these two amounts is only $[redacted]. This is the real amount at issue, since we decline to increase income under the bank deposits method for reasons stated in part c of this memorandum.

f. Disallow the entire amount of $[redacted] of rent reported on line 13 of page one of the Form 1065.

g. Disallow the entire amount of $[redacted] of depreciation reported on lines 16a and 16c of page one of the Form 1065.

h. Disallow each and every one of the 18 listed items of "other deductions" that total $[redacted], reported on line 20 of page one of the Form 1065, and delineated at Statement 1 attached to the return.

You can use the standard language used in abusive trust type notices of deficiency to disallow the claimed deductions that are listed at b. through h., inclusive, above. Alternatively, you can utilize the following language:

> It is determined that the expense claimed for (name expense)in the amount of $x,xxx.00, is disallowed because you have not substantiated that the expense was paid or incurred in a business activity of this partnership. You have also not shown that the partnership is the entity that is actually entitled to claim a deduction for the expense for federal income tax purposes, even if the expense is substantiated by you to have been paid or incurred during the calendar year [redacted].

You can combine as many expenses as you wish in one table to economize. The adjustments described above substitute for adjustments, respectively to, returns and allowances, cost of goods sold, and deductions that are currently in the proposed FPAA. These adjustments are the second, third, and fourth of the four adjustments therein.

c. Bank deposits analysis

A $[redacted] adjustment was made for unreported income, using the bank deposits method. We have discussed this adjustment with Wally Muncie. He agrees it should be eliminated. We discuss below why the adjustment should be eliminated in this case.

$[redacted] of gross receipts was reported on the Form 1065. According to the bank reconciliation at workpaper D-1, the total amount deposited into the single known bank account, less non-taxable loans of $[redacted], was $[redacted]. The difference between the determined taxable bank deposits, $[redacted], and the reported gross receipts, $[redacted], is the $[redacted] of unreported income.

Wally Muncie assisted us in locating the actual deposited items in the administrative file provided to us. There were [redacted] deposited items, which totaled $[redacted]. These deposits appear to have come from Workpapers D-21 through D-43. It does not appear that all the deposited items have been obtained.

Workpaper D-1a, entitled deposits, analyzes the $[redacted] of loans the Service has found. The $[redacted] of loans is comprised of three checks, one each tendered in [redacted], [redacted] and [redacted]. Given this pattern of loans made during the summer of [redacted], we think it is not inconceivable that another $[redacted] could have been loaned or otherwise transferred to the partnership tax free during the other nine months in the year.

A solid bank deposits analysis will hold up in court. See Rifkin v. Commissioner, T.C. Memo. 1998-180 (on appeal). When, as in this case, the taxpayer supplies no records, the Service may look at the bank deposits to evidence income. Nicholas v. Commissioner, 70 T.C. 1057, 1064 (1978); Sproul v. Commissioner, T.C. Memo. 1995-207. Once a bank deposits analysis is performed, the burden normally is on the taxpayer to prove that the deposits do not represent unreported income. Id. In Clayton v. Commissioner, 102 T.C. 632, 645 (1994), the United States Tax Court discusses the bank deposits method:

> Bank deposits are prima facie evidence of income, Tokarski v. Commissioner, 87 T.C. 74, 77 (1986), and the taxpayer has the burden of showing that the determination is incorrect. Estate of Mason v. Commissioner, 64 T.C. 651, 657 (1975), aff'd, 566 F.2d 2 (6th Cir. 1977). In such case the Commissioner is not required to show a likely source of income, id., although here she has done so. The bank deposits method assumes that all money deposited in a taxpayer's bank account during a given period constitutes taxable income, but the Government must take into account any nontaxable source or deductible expense of which it has knowledge. DiLeo v. Commissioner, 96 T.C. at 868.

The United States Supreme Court has stated that in utilizing the bank deposits method, respondent is generally required to investigate any leads regarding nontaxable sources of income that are "reasonably susceptible of being checked." Holland v. United States, 348 U.S. 121, 135-136 (1954).

Deposits, of course, will be considered income when there is no evidence they are anything else. United States v. Doyle, 234 F.2d 788, 793 (7th Cir. 1956); Kleinman v. Commissioner, T.C. Memo. 1994-19. In Kleinman, the Tax Court stated, "respondent made a diligent attempt to follow all leads in order to trace

nontaxable items," and found nothing more was required of the Service.

A taxpayer cannot wait until the last minute to tell respondent of leads. In Caparaso v. Commissioner, T.C. Memo. 1993-255, a taxpayer who waited until two weeks before the trial calendar to provide respondent with information about non-taxable sources of income had waited too long. See also, Tunnell v. Commissioner, 74 T.C. 44, 57-58 (1980), aff'd, 663 F.2d 527 (5th Cir. 1981) (vague leads as to cash on hand offered long after audit commenced with poor evidence not reasonable).

Some leads are not reasonably susceptible of being checked. In Daniels v. Commissioner, T.C. Memo. 1992-692 the Tax Court found that certain claims a taxpayer made for which he had no documentary proof were not reasonably susceptible of being checked by the Service. The Court observed:

> Petitioners did not offer any information which respondent failed to investigate. A taxpayer cannot complain about the sufficiency of an investigation where he has offered no leads. United States v. Penosi, 452 F.2d 217, 220 (5th Cir. 1971); Blackwell v. United States, 244 F.2d 423, 429 (8th Cir. 1957).

In a good bank deposits analysis the revenue agent will be able to demonstrate (s)he has: (a) reviewed very carefully each and every bank statement, deposit slip, and canceled check, (b) totaled all deposits made into all of the taxpayers' accounts, (c) searched for and credited the taxpayer with all possible transfers of funds between accounts, and (d) eliminated all non-taxable sources of income.

We think a good start has been made in the analysis of the bank account. However, based on its examination of the available deposited items, it appears a court could find the Service has been put on notice that other loans might have been made to the partnership during [redacted]. The court could then wonder why the Service did not use due diligence to obtain the remaining deposited items and analyze them to find: (a) additional loans, or (b) no additional loans or other non-taxable deposits.

In a case such as this, the onus is for all practical purposes on the Government to precisely demonstrate the four percent of additional deposits determined to be unreported income.[3] Even if we were to expend the required resources to

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[3] $[redacted] divided by $[redacted] = [redacted]. [redacted] is approximately a 4 percentage point increase. Alternatively,

prove the unreported amount, a court would wonder about its relative importance to other issues. Therefore, we do not concur with the additional unreported income adjustment you have found under the bank deposits theory in court. We recommend you do not increase income by $[redacted] in the final FPAA.

d. Substantial economic effect

I.R.C. § 704 (b)(2), and an exhaustive set of regulations thereunder, require that a partner's distributive share of loss be determined in line with the partner's interest in the partnership if a specific allocation to a partner does not have substantial economic effect.

We do not endeavor to review the regulations. It is factually apparent that: (a) if the partnership in fact is a partnership for federal income tax purposes, and (b) if it indeed had a taxable loss, then (c) after all of the facts are considered, the special allocation of 100% of the loss to one partner and no loss to the other partner lacks economic support. First, there is no partnership agreement upon which to test the substantial economic effect, if any, of the special allocation of all the loss to one partner and none to the other partner. Second, there are no other facts in the administrative file that justify the special allocation. Therefore, we opine that in the alternative, if [redacted] is imbued with life for federal income tax purposes, then the loss, if any, of the partnership, should be allocated the same way as profits, 50% to each partner.

Therefore, please disallow the allocation of 100% of the claimed loss to the [redacted]. You may use the following language to explain why this is being done:

> You have not substantiated that the allocation of 100% of the claimed loss to one of the partners and none of the claim loss to the other partner has either economic effect or substantial economic effect, as is required under I.R.C. § 704(b) and the Treasury Regulations thereunder. Therefor, if it is finally determined that this partnership had a loss for federal income tax purposes, then the amount of said loss shall be allocated fifty (50) percent to each partner.

e. Other matters

In our memorandum concerning the notice of deficiency that

[redacted] percent of the correct amount of income has been reported. [$[redacted] / $[redacted] = [redacted]%]

you plan to issue to the [redacted], we discussed at length the issue whether the Trust was the real partner. Therein, we opined that if [redacted] is a real partnership for federal income tax purposes, then the loss allocated to the Trust should still be disallowed for non-TEFRA reasons.

In our memorandum we stated as follows:

> We accept on its face that the [redacted] partnership is a TEFRA partnership. We have not reviewed the administrative file for it; however, the workpapers in the Trust's administrative file note the partnership is a TEFRA partnership.
>
> A partnership audit is made to adjust partnership items in a return of a partnership. I.R.C. § 6221; Boyd v. Commissioner, 101 T.C. 365, 368-369 (1993); Maxwell v. Commissioner, 87 T.C. 783, 787 (1986). Assessments of partnership items can only be made after partnership level proceedings are completed. I.R.C. § 6225(a). Any matter having to do with non-partnership items is resolved outside of TEFRA. Maxwell v. Commissioner, supra; Poison Creek Ranches #1 v. Commissioner, T.C. Memo. 1996-504. The Treasury Regulations define what a partnership item is in part as follows:
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> > To the extent that a determination of an item relating to a distribution can be made from...determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that item is not a partnership item.
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> Treas. Reg. § 301.6231(a)(3)-1(c)(3).
>
> Hang v. Commissioner, 95 T.C. 74 (1990), involved the question whether the Government's allocation of income to the beneficial owner of an S Corporation should be made in an FSAA proceeding.[4] The Tax Court found that the determination of the "true and beneficial shareholder"[5] was not a subchapter S item because the corporation would have no way to determine who the beneficial owners of its stock were. Id., 95

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[4] Subchapter S corporation matters were at one time TEFRA proceedings.

[5] Hang v. Commissioner, 95 T.C. at 80.

T.C. at 80. The Tax Court further reasoned that since shareholders have a right to participate in administrative and judicial proceedings, the beneficial shareholder would have to concede the issue of whether he was actually a shareholder in the FSAA proceeding in order to be permitted to participate in it. Id., 95 T.C. at 81-82. Therefore, the Tax Court concluded, "the determination of whether income should be reallocated from a shareholder of record to someone who is not a shareholder of record is more appropriately determined at the shareholder level." Id., 95 T.C. at 82.

In this case, the question is whether the loss from [redacted] should be allocated to the Trust, its partner in name and, we assume without knowing, the partner on its books and records, or to the Trust's trustee, [redacted], whom the Service contends is the true and beneficial partner. Under the reasoning of Hang, that decision should be reviewed in a judicial proceeding at the partner level, not at the partnership level.

Also, in this case, the partnership's books and records do not need to be consulted to determine whether the Trust is actually a partner in the [redacted] partnership. It is the Government that is taking the position the Trust is not a partner, because the Trust has no basis in reality.

Therefore, for the above reasons, we believe the Service's determination that the Trust is not entitled to any of the loss it claimed on its return from the [redacted] partnership should be made in a notice of deficiency issued to the Trust.

Having now reviewed the administrative file for the partnership, we do not believe any additional adjustment needs to be made to the partnership's FPAA, the Trust's notice of deficiency, or [redacted]'s individual notice of deficiency.

Please make sure that all of the procedural requirements for issuance of an FPAA are met.

Please contact Miles Friedman, at (949) 360-3430, if you have any questions.

Attachment:
Administrative File